MUTUAL FUND INVESTMENT

AFTER THE OCTOBER 1987 MARKET BREAK

An Industry and Investor Perspective

Research Department
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◆ SUMMARY OF INDUSTRY AND INVESTOR ACTIVITY ◆

◆ Industry assets currently total about $800 billion, only 5 percent below their record level, set in August 1987, in spite of the subsequent turbulence in financial markets.

◆ Sales volume of stock, bond, and income funds in 1988 is much more subdued than a year ago, but continues to be twice the level the industry experienced as recently as 1984.

◆ Current redemptions of long-term fund shares modestly lag 1987, but exceed earlier years.

◆ Diversification of mutual fund assets across a wide range of available portfolios places the industry in a better position for stability of assets than in earlier periods of market volatility. Data on activity during the week of October 19, 1987 suggest that the exchange privilege among funds contributes to this stability in addition to providing investors a convenient mechanism for responding to changes in the market.

◆ The majority of mutual fund owners, regardless of fund type, have taken little action since October 1987 to either redeem or exchange their funds. This is very likely due in large part to the long-term goals of many fund investors. Most of those who did move fund investments did not react immediately after October 19 but made changes over the following seven months.

◆ Mutual fund owners who moved money between October 1987 and May 1988 tended to exchange into money market mutual funds or redeem in order to buy bank CDs, indicating that these owners sought "secure" investments.

◆ The majority of all mutual fund owners now show greater concern for safety of principal than for achieving highest return when considering new or repeat investments. While safety has always been an important investment factor, it generally is not foremost in investors' minds during periods of sustained growth in financial markets.

◆ This conservative financial stance, while considered a normal reaction to increased market volatility, is a change from ICI shareholder research in 1986, which indicated that diversification of investments was the prime consideration of mutual fund investors among those investment factors given importance such as safety, *et al.*

◆ Seven months after October 19, owners of mutual funds invested primarily in stocks indicate more interest in achieving the greatest return on their money than immediately after the market break. This could in part be the result of stock fund owners' assumed greater risk tolerance compared to other fund owners, as well as a reflection of a

Note. This report is based on Investment Company Institute survey research with financial decisionmakers of households in November 1987 and in May 1988. The margin of error in using the survey data varies +/- 3 percent to +/- 10 percent, depending on sample size. In addition, the report describes the mutual fund industry sales and assets over the 1987 and 1988 periods including the specific week of October 19, 1987.

certain degree of renewed optimism stemming from more stable market prices.

◆ Seeking the advice of a knowledgeable investment person is particularly important to fund owners before taking any action to change current investments or make new investments in this climate.

◆ While attitudes are positive toward mutual funds as an investment vehicle among those who already own funds, there is no real preference given to mutual funds over other alternatives as an option for new investments among nonowners.

◆ The data from both surveys indicate that a majority of fund owners do not consider themselves particularly knowledgeable about the mutual funds they own and especially about the exchange feature offered by many fund families.

◆ The research found that fund owners are, for the most part, holding their present mutual fund investments, but are not making new investments. This finding is consistent with the low sales volume funds have experienced over this period.

◆ Communication with, and education of, the investor continue to be important fund management priorities since data indicate that fund owners, in their search for safety rather than highest return, are likely to talk with advisors and compare investment products.

◆ Owners of stock mutual funds are more likely than other fund owners to make changes in their current holdings, both in and out of mutual funds.

◆ Different groups of fund owners will respond to advice and to new products for different reasons. For example, while safety is of prime concern, equity fund owners in particular are more concerned about the return associated with their investments than the general mutual fund investor. Also, as a group, investors who bought their first mutual fund after 1985 consider themselves to be less knowledgeable about funds than long-term owners. While there is variation in the specific needs of different investor groups, the message of safety-oriented long-term investments, such as offered by many mutual funds, is likely to be received positively over time.

◆ ACTIVITY LEVELS IN MUTUAL FUNDS ◆

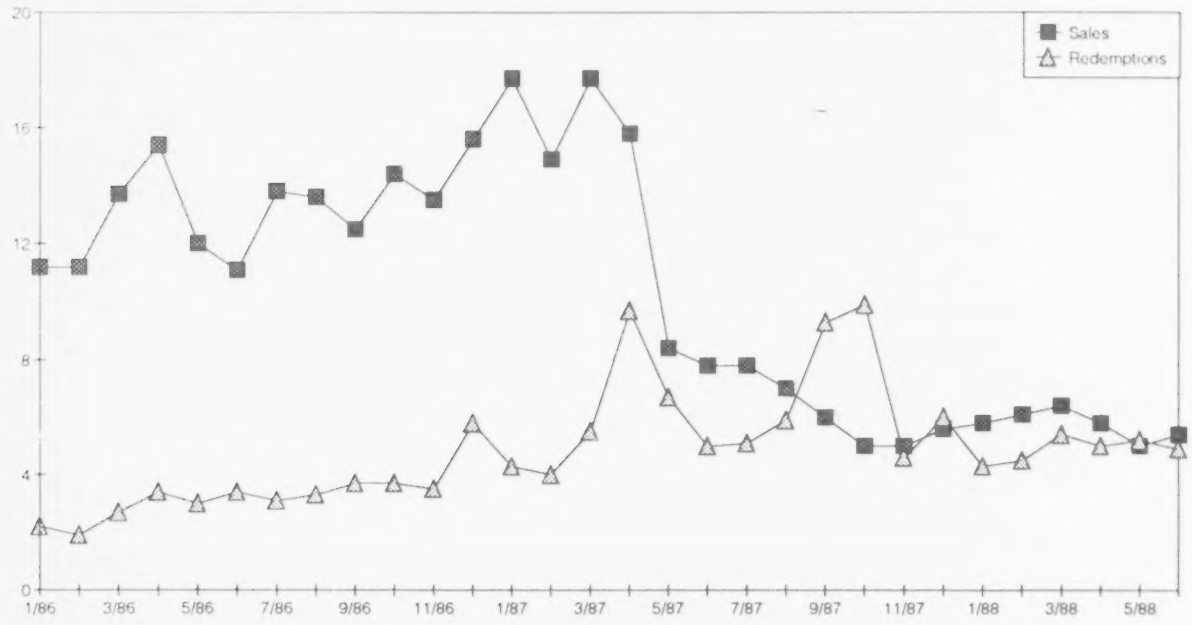
1987 MARKET CHANGES AFFECTED BOND & INCOME MUTUAL FUNDS

A fundamental change occurred in the mutual fund industry in the Eighties as growth in the bond and income sector dominated, even as stock funds were reaching unprecedented levels. In 1985 and 1986, three out of every four sales dollars of long-term funds were channeled into the debt sector.

The continued growth of these funds was adversely affected last year long before the stock market upheaval in October. In April, the rise in interest rates resulted in a corresponding decline in share value for these funds. Sales slowed dramatically, as the chart clearly demonstrates, and have continued at more modest levels ever since.

The surge in redemptions in May immediately following the price declines is evident, and one can readily see a similar increase in the early fall when rising interest rates again put downward pressure on share values. It should be noted, however, that these higher levels reflect short-term reaction to events in the marketplace, and for the intervening months of summer 1987 and for the months subsequent to the second interest rate rise in the fall of 1987, redemptions have been fairly stable at more normal levels.

Sales and Redemptions, Bond and Income Mutual Funds
1/86 - 6/88 (billions of dollars)



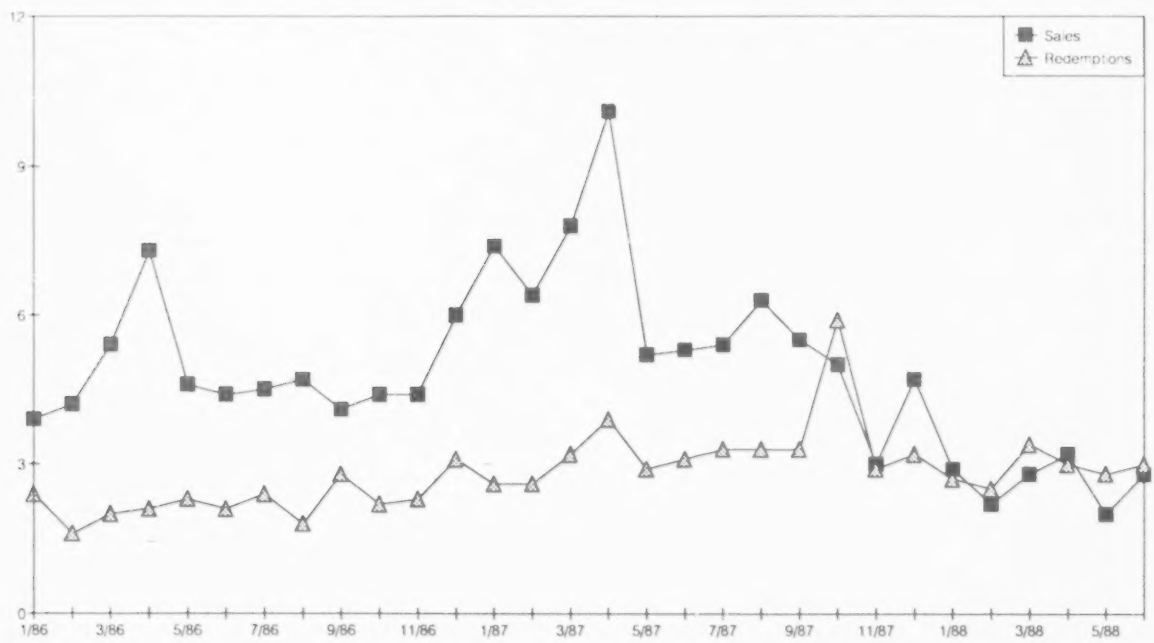
SALES AND REDEMPTION PATTERNS OF EQUITY FUNDS AFTER OCTOBER 19, 1987

Stock funds were, of course, adversely affected by the stock market declines posted last fall, especially in October. Sales sagged in November, rebounded in December on the strength of reinvested dividends, then retreated to more subdued levels which have prevailed since the yearend. It should be noted that the seasonally higher sales volumes in the first quarters of 1986 and 1987 evident in the chart were attributable to the inflows of Individual Retirement Account contributions. The favorable tax treatment given these contributions was sharply curtailed in the 1986 tax reform act. Therefore, sales volumes in the early months of this year have been to some extent dampened by the absence for many shareholders of the tax advantage of savings in their retirement program as well as the more uncertain financial climate.

The monthly redemption pattern shown in the chart is similar to that for the bond and income sector. Redemptions doubled in October, in immediate response to events in the marketplace, but subsequently retreated to more normal levels.

In essence, then, there has not been a tremendous run-off in assets via redemptions. Current sales levels are well below those in recent years, but assets have been retained. Some of that retention is a result of investors exercising the exchange privilege, shifting some of their investment from one type of fund to another within the same family of

Sales and Redemptions, Equity Mutual Funds
1/86 - 6/88 (billions of dollars)



funds. A special Institute study of industry activity during that historic week last October clearly demonstrates how this feature can serve the shareholder in periods of rapid financial change, and serve the industry in retaining assets.

EQUITY FUND ACTIVITY THE WEEK OF OCTOBER 19, 1987

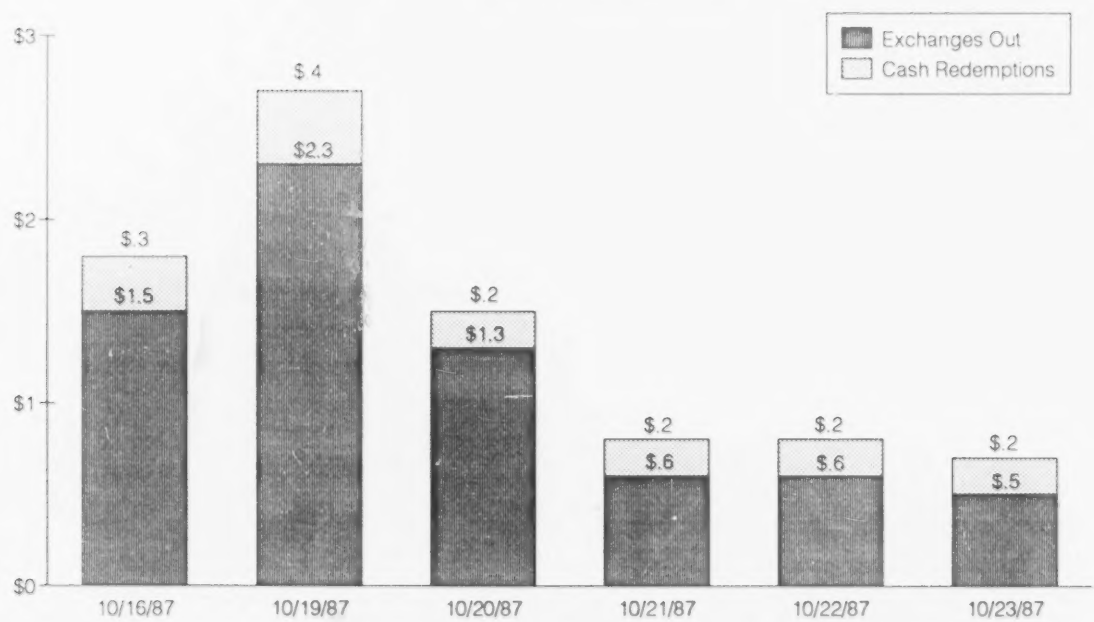
When exchanges and cash redemptions are combined, the study showed that exchanges out of equity funds, primarily into money market funds, accounted for about eight out of every ten dollars of *total* redemptions on October 19. Moreover, the ratio of exchanges to total redemptions was only slightly lower for most other days in the period surveyed. This means that investors who shifted out of equity funds into money market funds had available assets to move back to equity funds when they believed conditions warranted.

The high percentage of dollars redeemed which were retained within the fund families indicated continued shareholder confidence in the fund industry, even though, as with other investors, their preference for equities had temporarily declined.

MUTUAL FUND ASSETS

Current activity levels are well below their levels in recent years but assets have remained high. The inflow of new investments has been

Daily Activity of Equity Funds in October 1987
(billions of dollars)



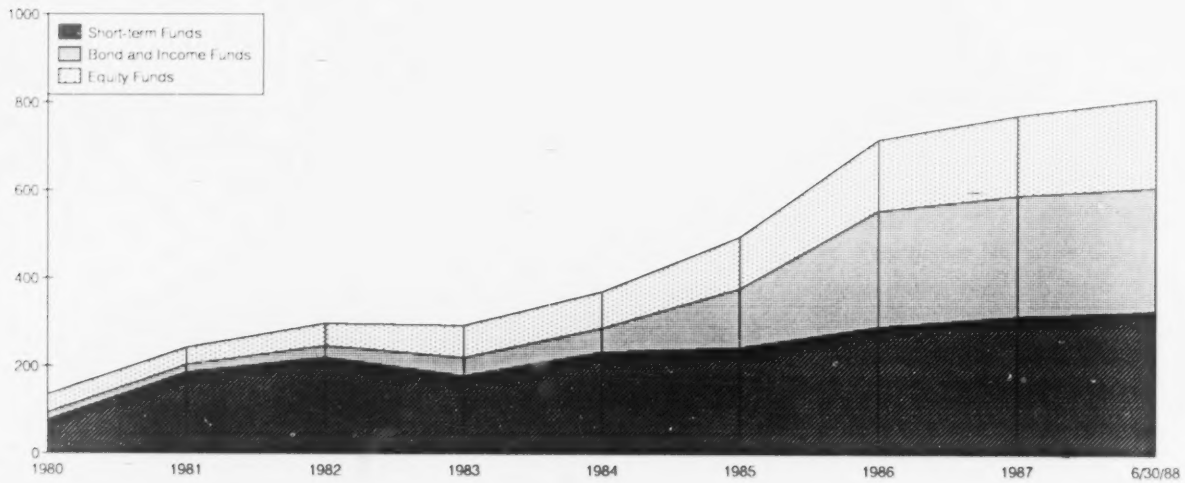
modest, but the industry has not experienced a significant outflow of dollars in part because of the much broader diversity of the industry. The chart demonstrates the more balanced distribution of industry assets in June 1988 compared with earlier years. What the chart does *not* show is the wide array of particular types of funds in the two long-term sectors which have been developed to respond to the ever-changing needs of the investor--needs which shift with changes in the economic and financial climate.

In the wake of market turbulence mutual fund managers have stressed more conservative equity portfolios--equity income funds and balanced funds. On the fixed income side, they are creating bond funds with shorter maturities in an effort to minimize price volatility. Flexible portfolio funds are also receiving more attention. And, of course, money market funds continue to provide investors an alternative with a high degree of safety.

DIVERSIFICATION OF THE INDUSTRY CONTRIBUTES TO ASSET RETENTION

Investor unease about the financial climate is reflected in lower activity levels in mutual funds in the wake of last October's turbulence. Lower trading volume on the exchanges similarly mirrors this activity. Not surprisingly, dollars have flowed into money market mutual funds as well as small-denomination time deposits since last October. Indeed, the latter have grown by over $100 billion in the last ten months.

Total Net Assets, All Mutual Funds
(billions of dollars)



If sales volume in the second half of this year is comparable to the first half, total annual sales will be nearly $100 billion. While this level is much more modest than the preceding two years, it will be twice the 1984 level. Annual sales volume in the Seventies was only $5 billion on average. During the early Seventies, this sales volume represented about 10 percent of total assets. During the severe downturn in stock prices that occurred in that period, mutual fund assets, most of which were in equity funds, declined 35 percent. Assets of bond funds were not significant and money market funds were just coming into existence.

As the preceding asset chart showed, the composition of the industry is substantially different now than at the start of the decade. A significantly smaller share of assets is held in equity funds. Since August 1987, assets of long-term funds have declined only 13 percent, reflecting the subsequent partial recovery of stock prices as well as the fact that a greater proportion of these assets are invested in the bond and income sector. The ratio of sales to assets for long-term funds was an extraordinary 50 percent in 1986. But projected figures for this year put that ratio at around 20 percent--twice the ratio of the early Seventies. These figures do not reflect activity in money market funds which are firmly established as an important component of the mutual fund industry.

Asset Levels in Short-term Investments
(billions of dollars)

	Money Market Mutual Funds	Small-denomination Time Deposits
9/87	241.3	873.2
10/87	254.9	885.6
11/87	259.7	903.8
12/87	254.7	914.6
1/88	272.4	929.5
2/88	276.0	944.5
3/88	274.8	953.7
4/88	270.0	960.5
5/88	268.2	964.2
6/88	261.7	970.0
7/88	262.4	978.7

INVESTMENT OWNERSHIP

Based on combined results from tracking surveys of financial decision-makers of households in November 1987 and again in May 1988, the Investment Company Institute found that mutual funds, including money market mutual funds, are owned by about one quarter of U.S. households. The survey also indicates that as of May 1988, about 8 percent of all households owned stock mutual funds.

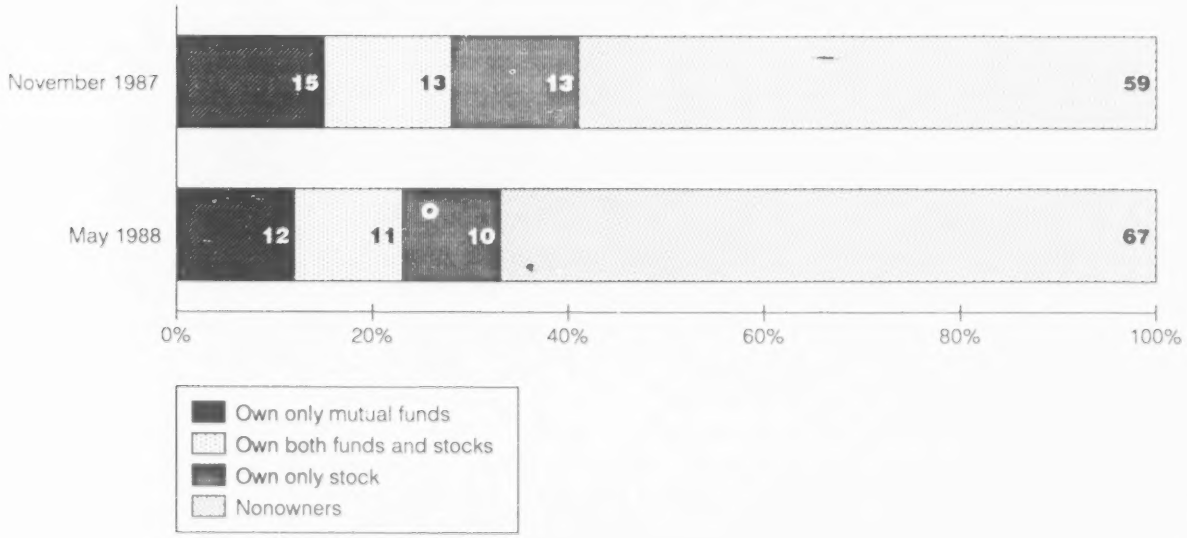
The ICI research identified only ownership of mutual funds and of individual stocks. This does not include ownership of individual bonds, for example. Within this survey universe, it is interesting to examine the relationship of households that own only mutual funds, those that own only individual stocks, and those that own both.

The following chart indicates that the number of households that owned only mutual fund investments and households that owned only shares in individual stocks declined between November and May in fairly equal proportions. This decline in ownership is primarily explained by the increased number of owners who sold or exchanged investments in the seven months after the October market break.

INVESTMENT ACTION TAKEN BY MUTUAL FUND OWNERS SINCE OCTOBER 19, 1987

The majority of mutual fund owners have taken no action to redeem or exchange funds since the October market break. As could be expected because of the seven-month interval between the surveys, a greater number of owners had sold or exchanged investments by May 1988 than in the first month after the market break.

Investment Ownership by U.S. Households



The data presented in the chart on page 11 show the actions of mutual fund owners in both November 1987 and May 1988 with regard to their ownership of individual stocks as well as their ownership of any type of mutual fund. In some cases where the sample size is small, as in the case of stock mutual fund owners, the margin of error increases, but comparisons between the two surveys remain valid.

ACTION TAKEN WITH MUTUAL FUND INVESTMENTS

Of all mutual fund owners in November 1987, 80 percent had taken no action with their stock or mutual fund investments since the market break while 61 percent had not taken any action by May 1988.

Five percent of fund owners took some action to redeem or exchange their stock mutual funds in the month after the break. By May, only 15 percent of fund owners reported having taken some action to redeem or exchange any type of mutual fund. As of May, 8 percent of fund owners had exchanged a mutual fund product for another type of fund within the same company. This does not include these fund owners' activity with individual stocks and, to the extent that any individual took multiple actions, these numbers would be lower.

The research identified the action taken by stock mutual fund owners specifically. Between October 19 and the November survey, 5 percent had exchanged their stock fund shares for other funds while 4 percent had redeemed these shares outright. By May, these percentages had increased to 9 percent and 11 percent respectively.

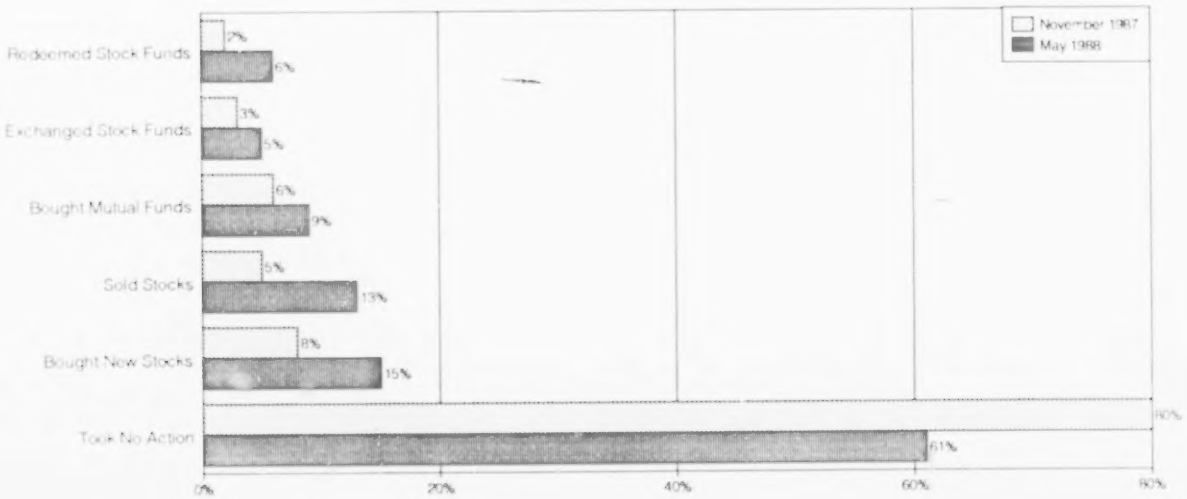
ACTION TAKEN WITH INDIVIDUAL STOCK HOLDINGS

Mutual fund owners also own individual stocks. By November, one month after October 19, 1987 5 percent of mutual fund owners had sold shares of individual stocks; 8 percent of households owning mutual funds had bought new stocks.

By May 1988, 13 percent of mutual fund owners had sold shares of individual stocks. Fifteen percent of fund owners had bought new stocks by May 1988.

In general, among respondents who took action to adjust any of their equity investments, many chose bank CDs and/or money market mutual funds for the new investments. As of May 1988, 9 percent of all mutual fund owners had bought new mutual funds and, as noted above, 15 percent had made new individual stock purchases since the market break.

Actions of Mutual Fund Owners Since the October Market Break



FAMILIARITY WITH MUTUAL FUNDS

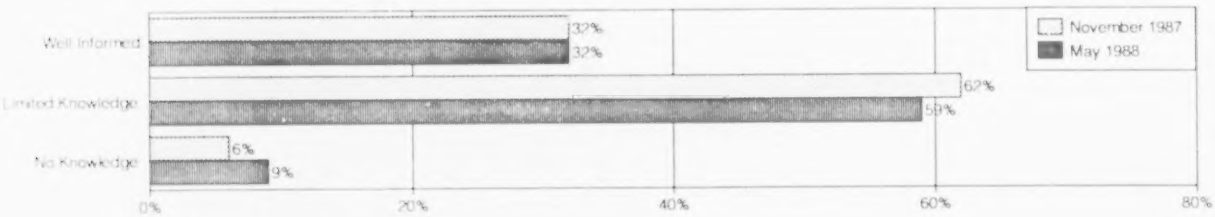
The surveys found that general awareness of mutual funds is high, even among nonowners of funds, but there is a continuing need for more and regular information and education among both owners and nonowners.

The majority of owners of mutual funds consider that they have only limited knowledge of mutual funds while about one third of owners say they are well informed. Owners who first purchased mutual funds before 1985 are among those more likely to consider themselves well informed.

About one fourth of owners are unfamiliar with the exchange feature offered within a family of funds. This is true among owners regardless of whether they had recently been introduced to funds or were long-time owners.

Among all survey respondents, regardless of whether or not they owned funds, awareness of mutual funds was fairly high; about two thirds of all households who replied indicated some knowledge of mutual funds. Awareness was highest among households with incomes above $35,000 and also where the respondent was between the ages of 30 and 65 years.

Fund Owners' Familiarity with Mutual Funds



IMPORTANT CONSIDERATIONS FOR INVESTING AFTER THE BREAK

Maintaining the safety of their initial investment was the main concern of mutual fund owners both immediately after October 19 and also in May 1988. In addition, the availability of advice about investments from a knowledgeable person was also an important factor for fund owners when making or changing investments after October 1987.

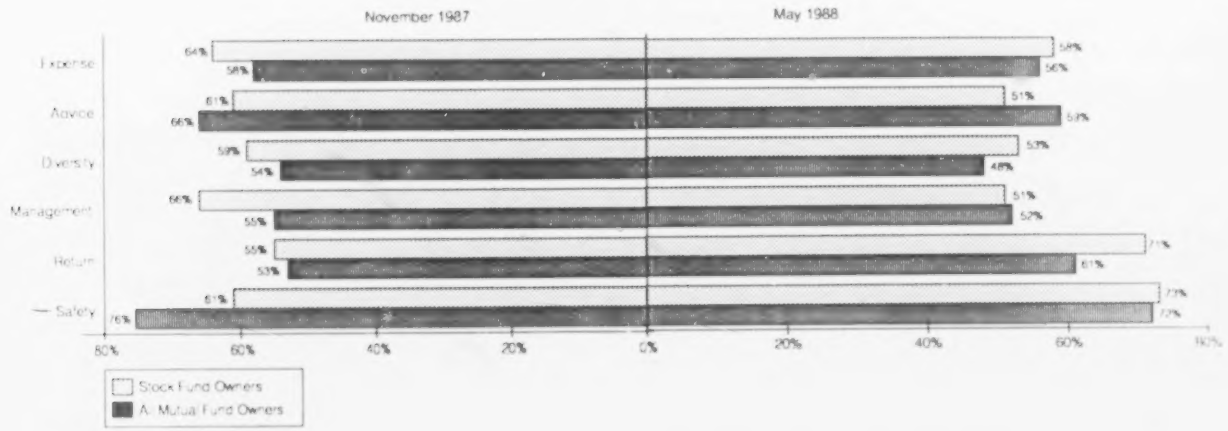
Return on investment was secondary in importance to several other factors immediately after the October market break, according to the November survey data.

Seven months after October 19, mutual fund owners continued to place safety of initial investment as the factor of greatest importance when investing. For all fund owners, return on investment was also an important factor in May 1988, more so than one month after the market break. Advice from a knowledgeable person was of great importance to the investors surveyed in both November and May.

Owners of mutual funds that were primarily invested in stocks had somewhat different priorities when investing immediately after October 19. Professionally managed investments were of greatest importance to this group of owners in November, more so than safety of principal. In May this group of fund owners showed much greater concern for safety as well as for trying to obtain the highest return on their investment. Owners of stock funds have usually been willing to accept more investment risk but the research results indicate that while they appear to be seeking higher returns seven months after October 1987, they are still very concerned with safety of principal.

As to be expected, the survey results show investor attitudes to the market continue to be cautious. Professional management and diversity of investment, both strengths of mutual funds, are important attributes when considering new investments, but in today's climate, they are clearly being weighed against safety and, for some, against achieving a high rate of return. The lesser emphasis by investors on diversification underscores the continuing need for education from the fund industry to help fund owners and nonowners alike understand the role of diversification in reducing risk.

Factors Considered Very Important For Fund Owners Contemplating Investments Today



Investors also need to appreciate more fully how the length of time an investment is held relates to that investment's volatility. As noted earlier, most fund owners had not redeemed or exchanged their fund shares even seven months after the market break. This suggests that many of them have a long-term investment horizon. As the period of time an investment is held lengthens, the impact of short-term volatility diminishes.

The table on page 14 demonstrates quite clearly the strong effect October's stock price break had on the average 12-month equity fund return. That one month negated the increases achieved in the preceding 11 months.

But as sharp as that stock price break was, the impact on the ten-year average annual return was quite modest. The 15 percent average annual return that equity funds achieved, even allowing for the downturn, is both attractive and competitive.

Figures such as these illustrate how length of time helps to reduce the impact of volatility. The longer an investor's time horizon, the more tolerant he can be of short-term swings in the marketplace.

Average Annual Return, Equity Funds*

Year Ended

	September 1987	October 1987
One Year	33.4%	0.6%
Ten Years	17.7%	15.4%

* ICI performance estimates compiled by Lipper Analytical Services

ATTITUDES TOWARD MUTUAL FUNDS AFTER THE BREAK

Respondents who owned mutual funds believed that they would be financially affected by the market break on October 19 to a greater degree than did nonowners of funds. One half of *all* survey respondents who were the financial decisionmakers in the household felt the October 19 market break would not be likely to affect them financially. Information on the extent of financial holdings of the respondents is not available; however, other ICI research indicates that fund owners are more likely to own a range of investment products and therefore would be more concerned than nonowners about the effect of October 19.

A clear majority of respondents who owned mutual funds at the time of the survey indicated that in the current market climate, mutual funds are a good investment. This response was highest for owners of stock mutual funds and indicates a positive attitude toward mutual funds rather than any preference for particular investment products.Owners of stock or bond mutual funds were somewhat less concerned about the risk to their principal investment than were nonowners of funds. This latter group indicated they would clearly look for future investments that offered no risks to principal.

While nonowners of mutual funds, particularly those with less familiarity with funds, appeared somewhat reluctant to invest in stocks or mutual funds in the near future, mutual fund owners said they would very likely in the near future invest in individual stocks, in stock mutual funds, or in income funds. Support for future investment in mutual funds or in individual stocks was highest among those who owned stock or bond mutual funds at the time of the survey. (Statement of intention cannot be related to specific future action and is therefore primarily further evidence of positive attitudes toward funds.)

Attitudes Toward Mutual Funds after October 19, 1987*

	Mutual Fund Owners	Nonowners, but Aware of Funds
Likely to invest in stocks in the near future	54%	47%
Likely to invest in stock mutual funds	58%	47%
Likely to invest in income-oriented funds	56%	47%
Mutual funds are good investments in this climate	67%	39%
Exchange feature of funds is a real benefit in this climate	74%	68%
Will seek only investments that protect principal	46%	62%

*percentage of survey respondents who selected these statements
(statements paraphrased from originals - November 1987 survey)

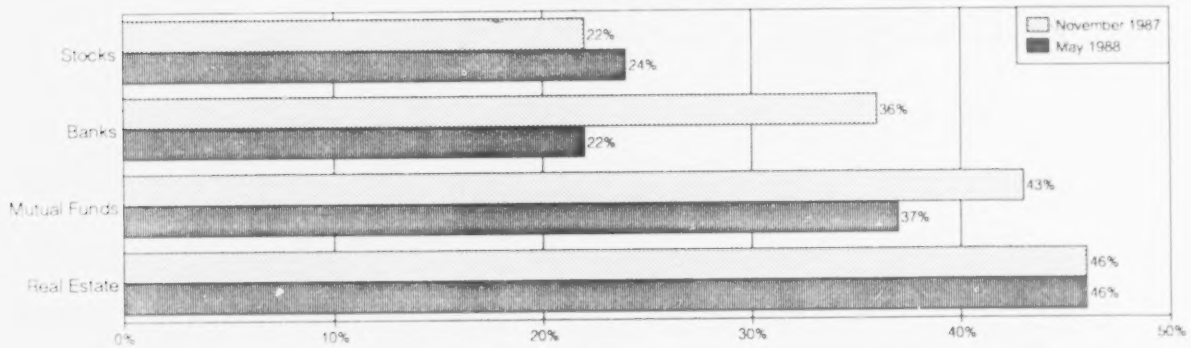
PLACEMENT OF FUTURE INVESTMENTS

All respondents were asked in the November and May surveys to consider which investment option they would choose assuming they had money to invest at that time. Mutual funds were a prominent choice for many respondents.

Both the Novernber and May surveys show that respondents who already owned some types of mutual funds are willing to consider them again for a future investment. Purchase of individual stocks was of lesser appeal than other investment options to owners of mutual funds. It is interesting that real estate was a popular investment choice for all categories of respondents. This interest in real estate (the research did not distinguish between real property and REITs or limited partnerships) underscores the investor's more conservative posture in spite of the fact that such an investment is generally less liquid.Interest in investing in bank instruments was greater immediately after October and dropped significantly in the May survey. For respondents who preferred bank instruments, a certificate of deposit was the most popular choice.

For respondents who said they would make new investments in mutual funds, government bond funds, stock funds, and money market funds were favored. As of May, all respondents who said they would invest in mutual funds, including nonowners of mutual funds, most often considered money market funds a priority, while owners of mutual funds expressed a slight preference for stock mutual funds.

Placement of Future Investments by Mutual Fund Owners



FUTURE PROSPECTS ARE FAR FROM DIM

Investors are clearly in a more cautious frame of mind. This conservative attitude, however, does not cause them to dismiss the possibility of choosing mutual funds for their investments. Indeed, the wide variety of portfolios available in the market today ensures that investors, regardless of their individual risk preferences, should be able to meet their needs through mutual funds.

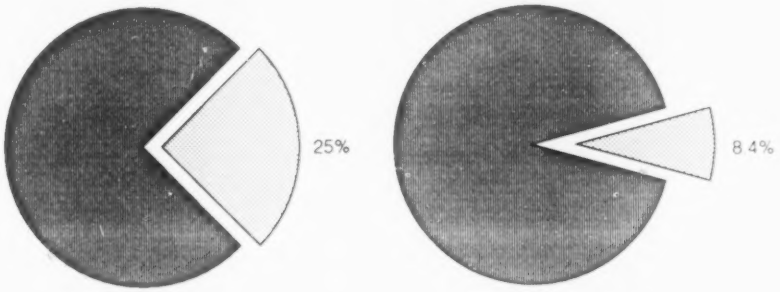
This suggests that the role of diversification, long proven of value to investors, is equally of value to the industry. Unquestionably, near-term growth will not be at the dizzying rates experienced in 1986 and 1987, but, when viewed from a longer perspective, the industry has positioned itself to enjoy greater stability than in earlier periods of market volatility.

In addition to the creation of new types of portfolios made available to investors, the industry continues to be innovative in its use of distribution channels, in pricing structures, and in enhancing the services provided to shareholders.

All of these factors suggest that mutual funds will continue to be a major provider of financial services. Prospects for long-term growth, although at slower rates than recent experience, are strong.

Consider, for example, that while ownership of funds is much more widespread today, funds' share of the total pool of financial assets in the U.S. is still quite modest. About one fourth of all U.S. households now own mutual funds, which is a dramatic increase over the 8 percent of households that owned funds in 1970. Since market penetration is greater for upper income and older households, it is very likely that as the older population groups increase in size with the aging of the "baby boom" segment, funds' overall market penetration will also rise. However, market penetration is only one measure of success.

Market Penetration of Mutual Funds in 1987



More suggestive of the growth potential is the amount of total financial assets represented by mutual funds. At the end of 1987, discretionary financial assets of households, including life insurance and pension reserves, totaled some $9 trillion. These assets need to be managed by someone--not to mention additional financial services which could be rendered. Mutual funds, in spite of their enormous growth in recent years, accounted for only 8.4 percent of that total. Clearly, there is ample room to expand market share.